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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1065

JOHN NUVEEN & CO., INC., a corporation, INVESTORS SYNDICATE OF AMERICA, INC., a corporation, and INVESTORS DIVERSIFIED SERVICES, INC., a corporation,

Petitioners,

—v.—

HENRY T. SANDERS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF LEHMAN COMMERCIAL PAPER INCORPORATED AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Motion of Lehman Commercial Paper Incorporated for Leave to File Brief as *Amicus Curiae*

Pursuant to Rule 42(3) of the Rules of this Court, Lehman Commercial Paper Incorporated, of 20 Exchange Place, New York, New York, hereby respectfully moves for leave to file the within brief *amicus curiae* in support of the Petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case. The consent of the Petitioners to the filing of such brief has been obtained. The consent of the Respondent was requested but was not obtained.

Status and Interest of Lehman Commercial Paper Incorporated

Lehman Commercial Paper Incorporated ("LCPI"), a subsidiary of Lehman Brothers Incorporated, investment banker, is a broker-dealer engaged in the sale of commercial paper, bankers acceptances and other money market instruments.

LCPI is one of the nation's principal commercial paper dealers. It acts as dealer for more than 100 commercial paper issuers, including many of America's leading industrial and utility companies. The aggregate amount of the commercial paper sold by LCPI and currently outstanding exceeds $2 billion, constituting approximately 12% of all outstanding commercial paper sold by dealers in the United States.

LCPI is directly affected by developments in the Federal securities laws involving commercial paper and the obligations and potential liabilities of dealers therein. The decision below—holding in substance that commercial paper notes sold by dealers may constitute "securities" for purposes of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and that a commercial paper dealer is an "underwriter" of such securities subject to liability under Rule 10b-5 for failure to make an adequate investigation of the issuer, even without a showing of actual fraud or reckless or willful conduct—is the most significant judicial pronouncement in this area in recent years.

LCPI believes that the decision of the Court of Appeals in this case did not give adequate recognition to the nature and special features of the commercial paper market, and that the decision will expose commercial paper dealers such

as LCPI to unreasonable burdens and risks of liability. Accordingly, LCPI requests leave to submit this brief as *amicus curiae* to call these matters to the attention of the Court.

Respectfully submitted,

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BRIEF OF LEHMAN COMMERCIAL PAPER INCORPORATED AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

The interest of Lehman Commercial Paper Incorporated as *amicus curiae* is set forth in the preceding motion for leave to file this brief.

Opinions Below

The Court of Appeals has rendered two opinions in this action. In its initial opinion (hereinafter, *"Sanders I"*), reported at 463 F.2d 1075 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972), it held that the short-term notes of Winter &

Hirsch, Inc. sold by Petitioner Nuveen to the Respondent were "securities" under the Securities Exchange Act of 1934[1] and Rule 10b-5[2] thereunder. In its more recent opinion (hereinafter, "*Sanders II*"), not yet officially reported,[3] the Court of Appeals reaffirmed the position it had adopted in *Sanders I* on the applicability of Rule 10b-5 to the Winter & Hirsch notes, and further held that Petitioner Nuveen was an underwriter of such notes and therefore liable to purchasers of the notes under Rule 10b-5 because, in the opinion of the Court of Appeals, it had failed to make an adequate investigation of the financial position of the issuer.

Questions Presented, Statutes and Rule Involved and Statement of the Case

In the interest of brevity, the statements contained in the Petition for a Writ of Certiorari (the "Petition") filed by the Petitioners John Nuveen & Co., Inc. ("Nuveen"), Investors Syndicate of America, Inc. and Investors Diversified Services, Inc. with respect to the Questions Presented, Statutes and Rule Involved, and Statement of the Case are hereby adopted.

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[1] 15 U.S.C. §78a *et seq.*

[2] 17 C.F.R. §240.10b-5. Rule 10b-5 was promulgated by the Securities and Exchange Commission under the authority granted to it by §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b).

[3] This opinion is unofficially reported at CCH FED. SEC. L. REP. ¶95,347 [Current Binder]. The *Sanders I* and *Sanders II* opinions are printed in the appendix to the Petition for a Writ of Certiorari herein.

REASONS FOR GRANTING THE WRIT

Introduction: The Commercial Paper Market

Commercial paper consists of short-term, promissory notes, normally unsecured, issued by finance, industrial, utility, mercantile and other companies and by affiliates of commercial banks. Paper of the larger finance companies and affiliates of commercial banks generally is issued directly to the purchaser by the issuer. The balance of commercial paper, including substantially all paper issued by non-financial companies, is issued through commercial paper dealers ("dealer paper"). Approximately six commercial paper dealers, including LCPI, account for most of the dealer paper sold in the United States.[4]

Dealer paper has played an increasingly important role in our country's money markets. From 1966 to 1975, the average dollar amount of such paper outstanding has grown from approximately $3 billion to over $17 billion.[5] For issuers, commercial paper serves as an important complement to conventional bank borrowings as a source of short-term funds to finance inventories, receivables and other working capital requirements. For banks, the availability of the alternative form of short-term financing accorded to borrowers by the commercial paper market significantly reduces pressures that otherwise would be imposed on the banking system to furnish short-term capital, particularly

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[4] *See* Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, at 367 n. 30 (1972); *see also* STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY, 274 (Aug. 1972).

[5] 61 FEDERAL RESERVE BULLETIN A-25 (December 1975).

in times of tight money. For purchasers, commercial paper provides a means by which excess funds that might otherwise be idle can be put to work in the short-term money market.

The commercial paper market, by providing an alternative to bank borrowings as a source of required short-term funds, materially enhances the liquidity of American business. The continued vitality of such market is thus of major importance to our economy.

The dealer, through his capital, his knowledge of the market and his distribution facilities, is the cornerstone of the commercial paper market. In almost all cases, the dealer acts as principal, purchasing the commercial paper notes for his own account from the issuer and reselling the notes to purchasers. He receives compensation by purchasing from the issuer at a discount calculated to produce a yield somewhat higher (normally ⅛ of 1% computed on an annual basis) than the estimated current market yield. The dealer may then resell the paper at the market price. In many instances, however, the dealer will not have arranged a resale at the time of his purchase from the issuer; the dealer's capital is therefore at risk in fluctuating markets. A dealer will typically carry ("position") a substantial inventory of paper running into several hundred million dollars. The dealer must himself arrange to finance his positions, and, when market conditions are unfavorable, the cost of such financing may exceed the yield to the dealer on the paper he carries. Despite such costs, the dealer must be prepared to position paper in order to assure issuers that the funds required by them will be available as and when needed.

The anticipated compensation to the dealer from the sale of commercial paper is significantly less than an underwriter's normal spread or profit in an underwritten sale of debentures, bonds or equity securities.[6] The market risks and interest costs of carrying large positions of commercial paper can materially reduce such compensation or result in losses to the dealer.

Commercial paper is rated by one or more of three nationally recognized rating agencies.[7] Most paper sold is rated in one of the three highest categories by at least one such agency.[8] In addition, dealers make and periodically update their own credit analyses of the issuers whose paper they sell, in the course of which they customarily review, among other things, the issuer's audited year-end financial statements, interim unaudited statements, bank lines, borrowings and other items, and make inquiries of officers of the issuer.

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[6] The normal underwriters' spread on long-term bonds is 7/8 of 1% of the face amount of the bonds. Thus, assuming an issue of $10,000,000 of long-term bonds, total underwriter compensation would be $87,500. By contrast, the compensation to a dealer from a $10,000,000 issue of commercial paper having a maturity of 90 days would be approximately $3,125. The discrepancy between underwriters' compensation in equity offerings and dealer compensation from the sale of commercial paper is even greater.

[7] Standard and Poor's Corporation, Moody's Investors Service, Inc. and Fitch Investors Service.

[8] Beginning January 1, 1976, as a result of the adoption by the Securities and Exchange Commission of amendments to its rules imposing minimum net capital requirements on broker-dealers (Rule 15c3-1 under the Securities Exchange Act of 1934, 17 C.F.R. 240. 15c3-1), dealer paper will be required to be rated by at least two such agencies.

I.

The Court Below Erred in Reading into Section 3(a)(10) of the Securities Exchange Act the Limitations of the Commercial Paper Exemption Under the Securities Act of 1933.

In *Sanders I* (reaffirmed by *Sanders II*) the Court of Appeals held that a promissory note having a maturity at the time of issuance of not more than nine months constituted a "security" for purposes of the Securities Exchange Act of 1934, 15 U.S.C. §78a *et seq.* (the "1934 Act"), and Rule 10b-5, 17 C.F.R. §240.10b-5 ("Rule 10b-5") thereunder, notwithstanding the fact that Section 3(a)(10) of the 1934 Act[9] expressly provides to the contrary. In so holding, the Court of Appeals, looking to its conception of "economic reality," concluded that the exclusion for short-term notes in Section 3(a)(10) applies only to commercial paper notes of the kind exempted from provisions of other Federal securities laws, particularly Section 3(a)(3) of the Securities Act of 1933[10] (the "1933 Act"), which exempts from registration under the 1933 Act short-term notes arising out of "current transactions."

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[9] Section 3(a)(10) of the 1934 Act states that as used in that Act the term "security" shall not include "any note . . . which has a maturity at the time of issuance of not exceeding nine months. . . . " 15 U.S.C. §78c(a)(10).

[10] Section 3(a)(3) of the 1933 Act exempts from the registration provisions (Section 5) of that Act any note "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months. . . . " 15 U.S.C. §77c(a)(3).

It is submitted that the unqualified exclusion in Section 3(a)(10) of the 1934 Act for "any" note having a maturity of nine months or less cannot properly be interpreted to cover only short-term notes of the kind exempted from the registration provisions of the 1933 Act. Such a limitation not only does violence to the express language of the statute, but is not supported even by the reasoning employed by the Court of Appeals in reaching this result. In its analysis, the Court of Appeals attempted to weave a common thread linking the coverage of the antifraud provisions of the 1933 Act with that of Section 10(b) of the 1934 Act. The court concluded that Congress could not have intended to exempt from Section 10(b), the antifraud provision of the 1934 Act, short-term notes which would not be exempt from the antifraud provisions of the 1933 Act. However, the court's attempt to equate the coverage of the antifraud provisions of the two Acts cannot be sustained because notes qualifying for the 1933 Act's Section 3(a)(3) commercial paper exemption, which under the court's reasoning would appear to remain exempt from Section 10(b) and Rule 10b-5, would still be subject to the 1933 Act's antifraud provisions (Sections 12(2) and 17).[11]

Moreover, the Court of Appeals—while doing violence to the statutory language by holding that short-term notes not entitled to the 1933 Act's registration exemption are subject to Rule 10b-5—added little if any protection to the purchaser of such notes: if the registration exemption is not available, the purchaser has the much clearer remedy of suing for rescission under Section 12(1) of the 1933 Act for failure to register the notes;[12] and even if the notes were

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[11] 15 U.S.C. §§77*l*(2) and 77q.

[12] Section 12(1) of the 1933 Act is quoted in note 16 *infra*.

registered, there would be no need to stretch to reach Rule 10b-5, since the antifraud provisions of the 1933 Act would expressly apply.

II.

In Determining the Availability of the Commercial Paper Exemption of the 1933 Act, the Court Below Applied Criteria That Make Commercial Paper Dealers Virtual Insurers.

If it is assumed, *arguendo,* that the limitations of Section 3(a)(3) of the 1933 Act can be imported into Section 3(a)(10) of the 1934 Act, nevertheless, the criteria adopted by the Court of Appeals, in its analysis of Section 3(a)(3), would make it impossible for any commercial paper dealer to determine in advance whether the paper it sells is exempt from registration under the 1933 Act and, as a practical matter, would make dealers virtual insurers of the paper they sell.[13]

The Court of Appeals, applying Securities and Exchange Commission Release No. 33-4412,[14] interpreting Section 3(a)(3) of the 1933 Act, stated that Section 3(a)(3) exempted from registration only "prime quality negotiable commercial paper" issued to facilitate "current operational business requirements" and of a type eligible for discounting by Federal Reserve banks. In determining whether the

[13] To the best of LCPI's knowledge, dealer paper is uniformly sold without registration, in reliance on the commercial paper exemption from the 1933 Act. Because of problems of timing and expense, it would be wholly impractical, for both the issuer and the dealer, to seek to register such notes.

[14] 17 C.F.R. §231.4412.

notes in the instant case met these requirements the Court of Appeals reasoned:

> "Thus, *because of the company's insolvency, it seems highly unlikely* that the paper purchased by the plaintiff and members of his class is either prime quality or issued to facilitate current transactions or eligible for discounting by Federal Reserve banks."[15] (Emphasis added.)

Under this retroactive analysis, if an issuer of commercial paper notes should default at some future time in payment of the notes, then the exemption from registration was not available at the time the notes were issued. Since no investigation by a dealer at the time of issue, no matter how thorough, can *guarantee* that the issuer is or will remain solvent and will pay the notes at maturity, *the dealer cannot know at the time he sells a note that it is exempt from registration.* If he nevertheless takes the risk of selling the notes in reliance on the exemption, and the issuer becomes insolvent, *the dealer will have no defense to a suit by the purchaser under Section 12(1)* of the 1933 Act for having sold the notes in violation of the registration provisions of the Act.[16] In short, if the decision of the Court of Appeals is permitted to stand, possible liability under Rule 10b-5 upon a default by the issuer—with which the

[15] 463 F.2d at 1079.

[16] Section 12 of the 1933 Act, 15 U.S.C. §77*l*, provides that "Any person who (1) offers or sells a security in violation of [section 5, 15 U.S.C. §77e] . . . shall be liable to the person purchasing such security from him, who may sue . . . to recover the consideration paid for such security with interest thereon . . . upon the tender of such security, or for damages if he no longer owns the security."

Court of Appeals was concerned—would be of academic interest to the dealer since he would have strict liability under Section 12(1) of the 1933 Act. Clearly, this impossible and unfair burden imposed on the dealer could not have been intended by Congress and is likely to have a significant chilling effect on the willingness of commercial paper dealers to continue to undertake the risks associated with the commercial paper market.

III.

The Opinion Below Imposes an Unreasonable Standard of Liability on Commercial Paper Dealers Under Rule 10b-5.

In *Sanders II*, the Court of Appeals, while stating that it was avoiding the "broad question" whether the standard of liability under Rule 10b-5 "lies somewhere between the extremes of common law fraud on the one hand and mere negligence on the other," held that a commercial paper dealer is liable under Rule 10b-5 if he fails to make a "reasonable" or "adequate" investigation of the issuer, thereby adopting a standard of culpability clearly based on ordinary negligence. In arriving at its conclusion the Court of Appeals applied, for Rule 10b-5 purposes, concepts created by and peculiar to the 1933 Act, *viz.* the obligation imposed by Section 11 of that Act[17] on an underwriter of a registered public offering to make a reasonable investigation of the accuracy of the registration statement. Thus, the Court of Appeals, describing Nuveen (the commercial paper dealer) as an "underwriter", relied on precedents dealing with the (Section 11) "due diligence" obligation of underwriters of registered public offerings (*Feit* v.

[17] 15 U.S.C. §77k.

Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), and *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968)) to hold that Nuveen was under a duty, enforceable through Rule 10b-5, to make an adequate investigation of the issuer.

It is submitted that, for the reasons set forth in the Petition (which in the interest of brevity will not be expanded here), the use of Section 11 precedents to determine the liability of a commercial paper dealer under Rule 10b-5 of the 1934 Act is wrong as a matter of law. In addition, the Court of Appeals' assumption that a commercial paper dealer is in the same position as an underwriter of a registered public offering is incorrect as a matter of economic reality. The commercial paper dealer does not prepare a prospectus and thus does not have the assistance of legal counsel in the preparation of a prospectus, as does an underwriter in a public offering; the commercial paper dealer's compensation is significantly less than the normal underwriting compensation;[18] the substantial legal and other costs associated with an underwritten offering could not be undertaken in a commercial paper transaction without rendering the transaction wholly impractical to both the issuer and the dealer; and, unlike an underwritten transaction, sales of commercial paper are conducted on a recurring basis over a substantial period of time so that a dealer subject to a "due diligence" obligation would be required continuously to be performing the kinds of investigations that a court or jury might deem appropriate for an underwriter.

Moreover, the specific investigation that the Court of Appeals here found necessary has not previously been ap-

[18] See note 6 *supra*.

plied even to traditional underwriters. The Court of Appeals concluded that Nuveen's investigation was deficient because it did not seek to examine the issuer's income tax returns or its auditor's work papers.[19] Yet these are items that underwriters ordinarily would have no reason to examine since they are not experts in accounting or tax matters and could not expect to obtain meaningful information from such papers. Absent some reason to believe that the financial statements are inaccurate, an underwriter is entitled, under the 1933 Act, to rely on the reports of auditors who are experts on such matters.[20]

The essential difficulty with the Court of Appeals' approach is that, in the event an issuer should fail to pay its maturing commercial paper, a court or jury is invited, with the benefit of hindsight, to find a deficiency in the dealer's investigation: whatever the dealer in fact investigated, no matter how thorough and diligent he was at the time, it will likely be found that he should have examined something else which (in the words of the Court of Appeals) "would have revealed the fraud or at the very least would have revealed deficiencies that would have mandated further inquiry."

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[19] The Court of Appeals also contended that Nuveen should have reviewed the issuer's minute books. Minute books typically are reviewed by counsel in an underwriting.

[20] Section 11(b)(3)(C), 15 U.S.C. §77k(b)(3)(C).

CONCLUSION

For the reasons set forth above, LCPI joins in the request of the Petitioners that a writ of certiorari be granted to review the opinions below.

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